Response to NCUA Announced Notice of Proposed Rulemaking
Corporate Credit Union Restructure

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Foreword

The Corporate Credit Union system has long been one of the core foundational elements of the entire credit union system. They are woven in to credit union "fabric" as deeply as are natural person credit unions. As such, their importance to natural person credit unions, both in the past and in the future, cannot be dismissed. Based on desire to serve their membership and the recent competitive nature of the Corporate environment, they have emerged as entities that not only serve the purpose of liquidity and transaction processing, but have become centers for cash ordering, ALM assistance, investment advice, hedging partners, and the list goes on. Because of the more recent investment market dislocation that currently endangers the capital structure and liquidity of our Corporate system, it is imperative that we separate out components of the overall Corporate structure that now hamper us from moving forward as well as those that provide benefit.

Today, the Corporates fight for survival as does natural person credit unions. They each want to "matter" and be considered viable. However, the changing financial landscape that is commoditizing credit unions and banks alike gives reason to think that a major restructure could be the most beneficial going forward. The Corporate system has begun to behave like a retail outlet driven by consumer demand, yet natural person credit unions depend on them more like a federal reserve bank. As such, we have competing demands that at times work at odds with one another for prioritization. Should the Corporates be retail organizations or should they be free from such concerns and be focused on the liquidity and safety/soundness concerns that natural person credit unions, at their core, need from the Corporates?

While some might argue that the retail nature of the Corporates helps keep prices low, it has also created the problems we now face because of the need to drive in greater levels of revenue. Costs continue to escalate, credit unions are demanding more and more, yet there are no mechanisms on the horizon to either provide substantial cost abatement or provide product/service offerings without increasing Corporates' operational costs. There will probably not be more natural person credit unions for the foreseeable future, so one must look at the realities that the number of Corporate clients is set to permanently diminish. For those that are concerned about pricing and competition at the Corporate level, we have only to look to external influences that help drive price comparison. Natural person credit unions will always have the option to obtain similar services outside the Corporate network. It is imperative, then, to somehow make processing within the Network financially appealing as well as appealing through levels of service that are incomparable.

Therefore, in my opinion, we must come back to the first rule of safety/soundness as the core objective of the Corporate. Once that element of the Corporates is again secured, we can layer in the retail components through product and service offerings that enhance revenue but do not negate or put at risk the core safety/soundness principles.

Concept

One of the major concerns that has surfaced over the past decade has been the national field of membership and increased competition within the Corporate network. While some might argue that competition is always good for the end user, we have to realize that competition already existed against the Corporate Credit Unions prior to membership nationalization. Natural person credit unions always had other options besides the Corporates in terms of serving their liquidity and transaction processing needs. The Federal Reserve, private entities, and correspondent banks were all options open to meet day-to-day requirements.

Because of the already thin margin for most Corporate Credit Unions, this additional pricing pressure from competition made it more necessary for them to seek revenue enhancement. While there have been additional products/services added that provided some income relief, improved investment returns became another avenue to enhance earnings. While added investment risk was being introduced into Corporate Credit Union balance sheets, compensating capital and liquidity outlets were not as well defined. Inasmuch, it appears that investment guidelines were established in terms of risk potential from what has been known to us over the past 2 decades. We are now beginning to realize the true risk nature of the investment portfolios many Corporates have accumulated, and we recognize that during severe downturns the more optimistic expectations have not come to fruition. Instead, the entire credit union system is faced with potential losses that would be catastrophic if fully realized.

It is my belief that what the Corporates are trying to do for their membership is not inherently the problem. It seems the issues are environmental (external and internal network competition, recession) and enhancements needed for risk management. Therefore, I would recommend that we:

1) Consider realigning the Corporate network to match the Regional NCUA system and continue to allow them to provide the same types of services that are offered today. In doing so we can reduce the operating costs to the Corporates (less Corporates but more clients per Corporate), eliminate internal competition that reduces margin, and allow them to partner more closely with one another without fear of losing natural person credit union clients.
2) Improve the oversight at each Corporate through a restructured Board and Committee program.
3) Encourage restructuring the "back office" components of the Corporate system, possibly through shared technology, accounting, marketing, etc.
4) Change the investment rules and regulations for Corporate Credit Unions to divide investment functions for natural person credit union dollars and investments made on behalf of the Corporate Credit Union (excess capital).
5) Change some of the capital components of the Corporate system to improve risk management, ensure the Corporates are more self-reliant, reduce risks to the natural person credit unions, and allow for risk-taking and enhanced earnings in areas that are more suited for that type of activity. Provide for share insurance for the Corporate system.
6) Continue to have the 5 regional Corporates utilize US Central as their main source for liquidity and investment needs.

Each one of the six (6) components is outlined below.

<u>1. Corporate Credit Union Realignment</u>

While I recognize that realigning the existing Corporate network down to 5 Regional Corporates is a large undertaking, it seems like the most judicious. Many times in our nation's history, businesses and individuals that had come to a "cross road decision" and were at a point where they were able to create real change failed to make the radical decisions that gave them relevance in the future. I believe our Corporate system is at that "cross road decision" point. While this may be marginally painful in the short term, it poses the best long-term solution for all involved. Of course, this would relegate all natural persons within a specific NCUA Region to belong to the Corporate from that Region, and cross-memberships to other Corporates would be eliminated. But, such cross-memberships would be unnecessary because all Corporates would be providing the same service at the same rate.

The Corporate system will benefit in that the inter-competition will be eliminated. This will allow our Corporates to partner fully and thoroughly and encourage them to seek cost-saving measures of their own accord. Natural person credit unions will benefit in terms of improved pricing that should come as a side benefit of operation cost reduction. Additionally, we will have Corporates that are more financially healthy and stable as well as positioned to withstand future economic strains.

Because of the amount of time/energy that this involves, it should have a timetable of approximately 24 – 36 months to complete. A systematic method should be devised to prioritize the merger of Corporates within the Region that considers existing FF&E costs and ease of migration. However, the realignment should begin across all Corporates and not linear in that some of the Corporates sit and wait. Each should be given a set of pre-merger tasks to begin immediately. Natural person credit unions should also be provided a timetable as to when their Corporate will merge away and when they need to have all their new processes in place to be served from the new entity.

Because of processing issues related to using certain vendors and systems, the surviving Corporate should work with each Corporate being merged away to determine how best to serve the natural person credit union clients. It might be that some of the Corporates' ancillary product arrangements will have to move into a CUSO function to be managed while resolutions are reached. If this were done at all Corporates across the nation, all natural person credit unions using certain types of vendors may still be able to be served under a national CUSO processing agreement of some sort.

All of the Corporate assets being merged away will become the property of the surviving Corporate. It would make sense to merge the smaller Corporates into the largest entity as the larger Corporates are already set-up to manage the various products/services that are expected to be delivered post-merger. While some of the natural person credit unions will have their Corporate possibly merged away and have to realign into another Region, the net affect should be minimized through the net losses and gains between each Region.

Once the realignments are completed, all products/services provided pre-merger throughout the Corporate Credit Union system should still be available post-merger. This helps ensure low-cost alternatives to natural person credit unions of smaller size but also provides the sophistication and level of service expected from the extremely large natural person credit unions. If the level or types of products/services offered were to erode or be removed, it would limit the "attractiveness" of the Corporates to most natural person credit unions (especially as you move out into the future and more credit unions become larger). It may be that some of the services are provided through a CUSO type function, but if it is within the Corporate Credit Union "family" should still come under the oversight function of the Corporate as a whole. Also, some of these types of agreements could be combined so that maybe 1 or 2 of these CUSO's could support the entire Corporate system (ALM services, mortgage services, etc.).

2. Corporate Credit Union Oversight

My recommendation is to have 9 Board members at the overarching Corporate level. No one is going to care about the future of a Corporate and its cost/service abilities than the credit unions the Corporate serves. Therefore, I would recommend that the Board consist of 2 members from each level of natural person credit union asset size and the CEO of the Corporate. As such, the Board would be comprised as follows:

2 Board Members from Credit Unions in Asset Size of Less than $100m
2 Board Members from Credit Unions in Asset Size more than $100m and less than $250m

2 Board Members from Credit Unions in Asset Size more than $250m and less than $500m
2 Board Members from Credit Unions in Asset Size greater than $500m
1 Board Member the Corporate Credit Union CEO

No Board Member would be able to serve more than 5 years (consecutive or cumulative) on the Board, but would be able to serve at the Committee level up to 7 years. From the Board's members, they would elect a Chair, Vice-Chair, Secretary, and Treasurer; the Corporate Credit Union CEO would not be able to hold an executive level position on the Board. All Board Members that are not in executive positions would head up the ancillary Committees.

A thorough training program is to be developed for all Corporate Credit Union Board members that provides insight and education into all aspects of the Corporate Credit Union's processing, liquidity management, and investment functions. The training will be mandatory for Board Members and each must sign a statement signifying they understand their duties and roles.

Committees would consist of no more than 5 persons each and comprised of 1 Committee Member from each asset size of natural person credit union as noted above. The 5th individual would be the Committee Chair as appointed by the Board. Committee members may serve no more than 7 years on any individual Committee, but may serve in other Committees. A staff member of the Corporate will be assigned to each Committee and be required to report the affairs of the Corporate; however, the member of staff will have no voting power in the Committee. Committee types could be as follows:

ALM Committee
Supervisory Committee
Investment Committee
Operations Committee (Transaction Processing)
CUSO Oversight Committee

Oversight at US Central would be as follows:

4 Board Members from the various asset sizes of natural person credit unions as outlined above
5 Board Members from each of the Regional Corporates
1 Board Member the CEO of US Central
1 External Board Member that could be a content expert of some sort

3. Back Office Restructuring

If all the Corporate Credit Unions are no longer in direct competition, they will be able to do more sharing across boundaries and possibly utilize joint back-office operation partnerships. Here again, the benefit to natural person credit unions is the elimination of cost. Although not mandatory, it would behoove each Corporate to participate in order to help reduce costs, build capital and ultimately provide refunds back to Corporate members at the end of the year or use excess capital to contribute to a new product/service.

US Central could play the role as a centralized processing unit, or certain roles could be assigned out to individual Corporates. For example, one corporate could hold the centralized Accounting and another hold the technology component. Of course, these are just suggestions – but reduction in cost would be the key.

4. Investments

Investments of money from natural person credit unions must now be monitored and measured separately from the money the Corporate invests of its own capital. Investment Committees can work in concert with Operations staff and any new NCUA regulations to determine the best course of action with regards to laddering and investment mix to provide a constant source of liquidity and still maximize earnings.

Corporate Credit Union money that is being invested (excess capital investment) could be open to greater levels of risk investments, up to a defined percentage as agreed upon by NCUA. The higher the level of capital, the greater the amount of risk the Corporate can take with these segregated funds.

The Investment Committee must be able to demonstrate full knowledge of all the investments held by the Corporate and know their risk profiles, how they perform under market stressed conditions, loss potential based on recent levels of similar investment performance, and liquidity changes based on rate environment (collateralized obligations). These reports will be provided to the Board of Directors at least quarterly so performance-against-target can be monitored.

I would not recommend a change to the investment authority provided to Corporate Credit Unions, but there may need to be stronger parameters built if a Corporate does invest in CDO's, corporate paper, etc. There needs to be a demonstration of understanding at the Corporate level and a limitation of percentage of investment mix to capital. If the Corporate has a larger amount of capital, the Investment Committee should be able to take a stronger risk position. Eliminating their expanded investment authority does not make sense to me because this really came down to a concentration issue and not a capability of management issue.

I'm sure there needs to be thoughts around liquidity measurement in addition to just capital at risk when contemplating investment mix profiles. This could be worked out in a joint task force between NCUA and the Corporate investment professionals (with some input from external consultant/experts – PIMCO).

5. Capital

I am in favor of changing the capital structure for Corporates away from paid-in-capital accounts supplied by natural person credit unions. Each Corporate must be able to stand on its own capital and not put their natural person credit unions at risk, and as such will probably require new capital standards into the future. However, if we become better at managing the risk profile at each Corporate – capital standards should not pose a large problem.

Each Corporate should be required to hold no less than 4% capital; but, this is now capital that will have to come solely from earnings. The level of capital maintained should be adjusted upward based on the types of investments being held and the amount of loans outstanding on the Corporate's portfolio (loans to natural person credit unions also pose potential risk if unpaid). As paid-in-capital accounts no longer count towards the ratio, Corporates should be allowed 5 years to reach the new capital standard. All income that exceeds the new capital ratio (adjusted capital standard based on investment mix and loans) should be returned back to natural person credit unions at the end of every year in the form of an additional dividend. This would encourage natural person credit unions to ensure their Corporate was profitable and would act as an additional incentive to use the products/services.

If Corporates fall back below the 4% ratio (or adjusted capital ratio), they must provide NCUA and the Board of Directors a plan to restore the capital ratio back above minimum limit within 24 months. Higher risk investments must be within a certain risk tolerance of total capital and ensure no more than a standard amount of capital is ever at risk. For Corporates that are effective at managing their risk investments and loan portfolios, they will be able to provide their natural person credit unions with greater levels of return or lower costs on ancillary products/services. I am, also, in favor of trying to use the CLF as a capital back-stop during periods of reduced capital – as long as NCUA believes the Corporate is viable going forward and the CLF can be repaid in a reasonable period of time. This seems like an option that could be explored further.

In order to provide additional stabilization to the entire credit union system, it is recommended that a separate NCUSIF be set-up to guarantee Corporate Credit Union deposits. Corporates would hold a portion of funds on deposit with NCUA, similar to natural person credit unions. Operating fees would be paid to NCUA and the fund would hold a much lower level of reserves due to the lower likelihood of a Corporate failure (fewer number of Corporates and lower risk profile).

Finally, some sort of permanent access to the Central Liquidity Facility should be provided to the Corporate Credit Union network on the liquidity side (not just as a capital back-stop) and a sliding scale be established in terms of how Congress should set the limit (based on % of total credit union assets, etc.). This way, we would no longer be required to request an amendment or change to the Facility, but NCUA could simply report the levels and usage and the CLF would automatically adjust to the required level.

6. US Central

It is understood that access to certain investment markets can be more effective when resources are pooled. Because of this, liquidity and earnings can both be enhanced through some sort of wholesale organization that is assisting all Corporates with these needs. US Central currently fills that void, and it seems to me to be prudent to hold that structure in place. However, their investments in the future must be modified to conform to the new risk-based standards and rely on net income to create earnings. Depending on the risk profile going forward, lower levels of capital may be needed. NCUA should set the level at one that resembles the risk profile and earnings potential for US Central in this new paradigm. All excess capital amounts should be returned to the retail Corporate Network in the form of dividends.

Furthermore, US Central and the Corporate Credit Union system should be required to reimburse the NCUSIF for all funds that were recently disbursed for the investment losses. The reimbursement schedule could be spread out over several years in order to help the Corporates achieve their new capital targets yet still repay their obligation.